FitchRatings

State Pension Update

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State Pension Update

Credit ratings & the role of pensions

Major pension trends

States’ pension burdens

Takeaways

Questions?

FitchRatings

Credit Ratings & the Role of Pensions

The purpose of credit ratings

- An opinion on the relative ability of an entity to meet financial commitments
  - Degree of the financial challenges likely to be confronted
  - Tools to deal with those challenges
  - Extent to which those tools expected to be utilized
- Expressed globally on the ‘AAA’ to ‘D’ scale
  - Most US state and local governments very strong relative to global comps

Credit Ratings & the Role of Pensions

Pensions analyzed within *key rating factors*

- Economic framework: driver of revenue potential, spending needs
- Revenue and expenditure frameworks
  - Legal ability to control taxes and spending
  - Focus on contribution affordability now and longer-term
  - Cost of supporting relative to other demands
- Long-term liability burden
  - Extent and nature of liabilities, outlook for the future
- Operating performance
  - Legal and institutional framework
  - Ability, willingness to actively manage their liabilities

Credit Ratings & the Role of Pensions

Debt & pensions viewed as effectively equivalent

- Long-term, “debt-like” burdens
  - Challenges to comparability: volatility, assumptions, disclosure differences
- Metrics to understand fiscal impact
  - Balance sheet: tax-supported debt + unfunded liability
  - Income statement: carrying cost = debt service + ARC/ADC
- Role of management: willingness/ability to focus on problem-solving
- Vast majority of governments able to respond to pension challenges
  - Rating changes in some cases: IL, NJ, KY, PA, CT

Major Pension Trends

Fitch's annual state pension update

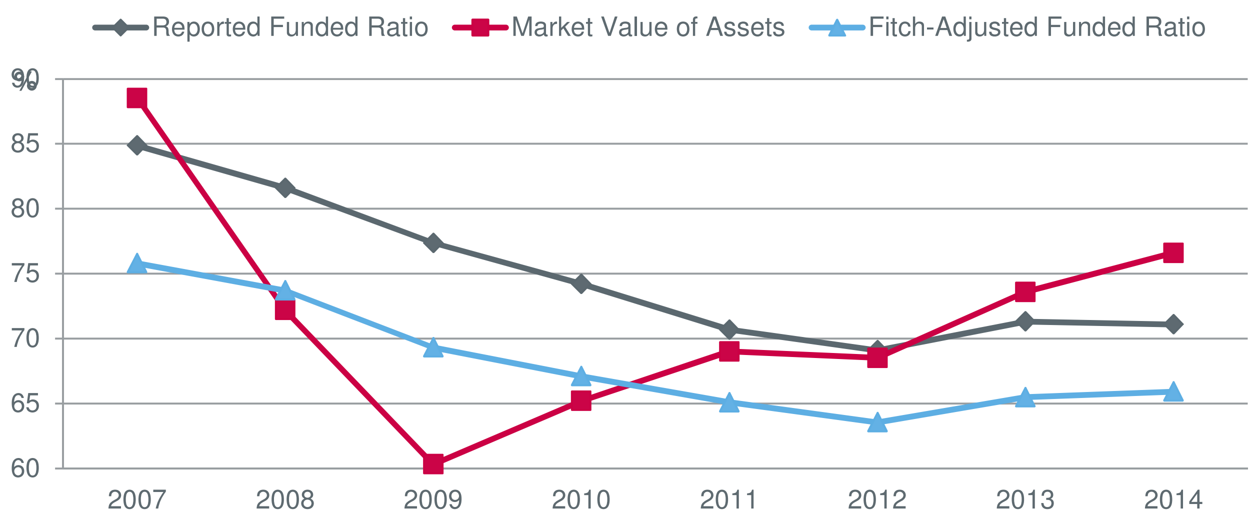
- Latest released in October 2015; mostly reflects 2014 pension data
- Two focuses
  - Burden on individual states: debt + pensions as % of personal income
    - Approximately 225 defined benefit pensions in state CAFRs
  - Trend & status report on biggest state-wide plans
    - Analytical focus on "material" plans – about 100
    - Sometimes just state, more typically multi-employer

Major Pension Trends

Status: reported funded ratios stabilizing; no recovery in sight

- Funded basis: since 2012 trough, ratios up only slightly
- Market basis: since 2009 trough, ratios higher but not to prerecession level

Comparative Ratios of Assets to Liabilities



Major Pension Trends

Why not more improvement in this recovery?

- Magnitude of recessionary market losses
- Mixed market performance since then
- Falling investment return assumptions → rising actuarial liabilities
- Most benefit reforms affect only new workers; limited impact to date
- Persistently inadequate contributions
- Actuarial experience pushing liabilities higher

Major Pension Trends

GASB 67/68 implementation still underway

- Fiscal 2014 system CAFRs subject to GASB 67
- Fiscal 2015 participating governments' CAFRs subject to GASB 68
- Even with new standards, wide divergences in states' CAFR reporting

Major Pension Trends

GASB 67/68 having some positive impacts

- Improved comparability of reported figures
  - Entry age normal cost method for liabilities
  - Market value of assets
- New tools to understand the liability and risks
  - Clear allocation of obligations to all employers (CSME plans)
  - Clear definition of obligation when a non-employer plays role in funding (“NECE”)
  - Sensitivity analysis a window on duration of liability
- Greater clarity with dollar value of “normal”/“service” cost and amortization
  - Normal cost provides a “true” current year benefit cost

Major Pension Trends

GASB 67/68 also has some challenges

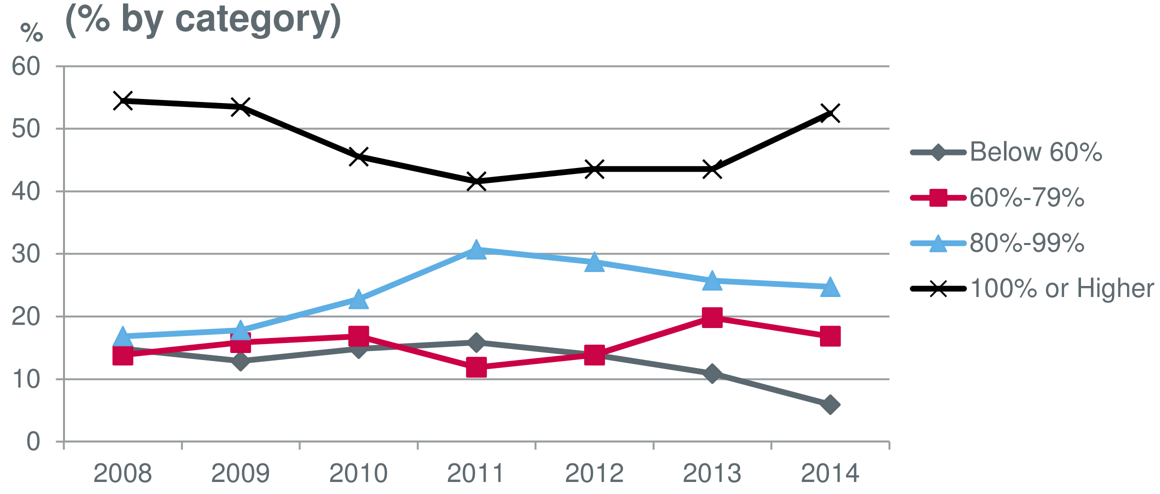
- Ratio of assets to liabilities more volatile
- ARC takes on a lower profile or disappears altogether
  - Especially for CSME participating governments under GASB 68
- "Depletion date" adds little value
- Separation of accounting from "funding"
  - Contribution section of notes often of limited value
- Mismatch between new standards and some states' institutional framework
  - "NECE" reporting may/may not equal actual state responsibilities
  - Risk of "orphan liabilities"
- Agent plans' CAFRs now incomplete

Major Pension Trends

Contribution trends for major plans improving, but still inadequate

- 53% received 100% of ARC/ADC in 2014, up from 42% in 2011
- Average actual contribution now at 91% of ARC/ADC, up from 85% in 2011

Plans' Actual Contributions/Actuarial Contribution (% by category)



Major Pension Trends

Contribution trends improving, but still inadequate

- Problematic practices fall into 2 categories
  - Consistent underpayment relative to ARC/ADC, regardless of fiscal cycle
    - Statutorily fixed contributions without periodic reset
  - One-time cuts temporarily as a gap closer
    - Very widespread in recent downturns
- Fitch views both as deficit financing

Major Pension Trends

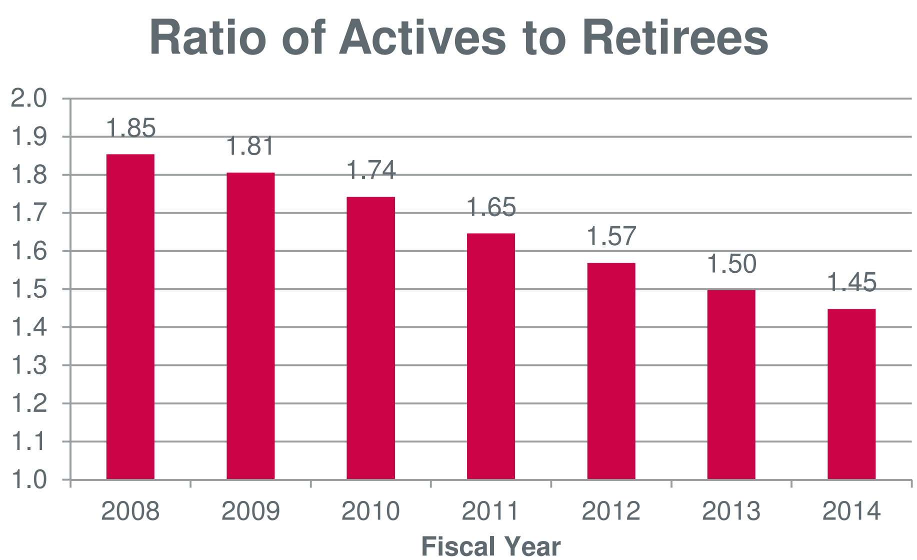
ARC never was a great benchmark for contribution sufficiency

- Actuarial practices allow wide range of assumptions
  - Primary goal for state and local pensions—contribution predictability
  - Offsetting goal—paying down liability—becoming more important
- Potentially problematic assumptions
  - Rolling, 30-year amortization resets clock each year
  - Level percentage of payroll backloads amortization progress
  - Era of consistently high investment returns likely over, at least for now
- Worst case scenario: UAAL rises annually even though ARC is fully paid

Major Pension Trends

Demographic erosion a medium and long-term threat

- Structural trends (outside of market cycles) very unfavorable



Major Pension Trends

Demographic erosion a medium and long-term threat

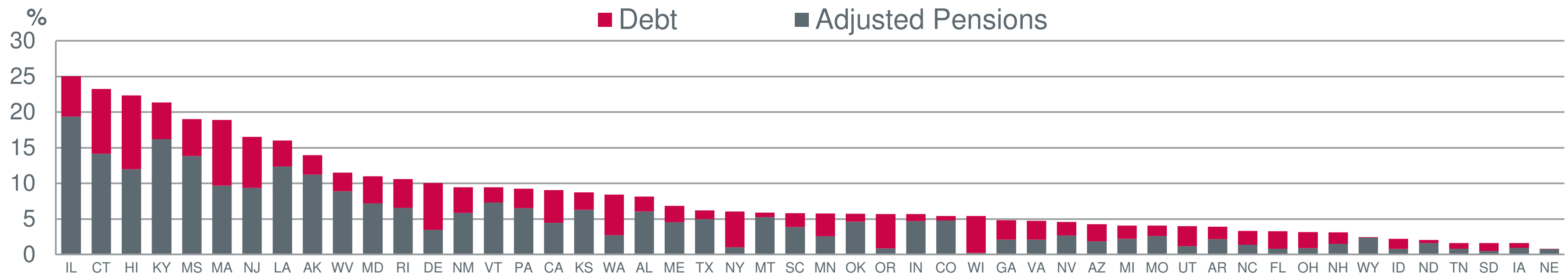
- Evidence of weaker demographics
  - Public employment flat
  - Retiree numbers rising and retirees living longer
  - Duration of systems' liabilities falling
- Adds stress to systems and participating governments
  - Lower contributions from actives to help amortize UAAL
  - Higher benefit payments require shorter-dated investments
  - Harder to recover from market shocks
  - Magnifies negative impact of contributing less than the ARC/ADC

States' Pension Burdens

Wide range of states' debt + pension burdens as of latest data

- Median equals 5.8% of personal income
  - High at 25% (Illinois)
  - Low at 0.8% (Nebraska)

Net Tax-Supported Debt and Adjusted Pensions as a % of Personal Income



States’ Pension Burdens

Wide range of states’ debt + pension burdens

- Fitch measures liabilities against each state’s personal income base
- Debt component lower: median at 2.4% of personal income
  - Reflects careful state management of debt
  - Low of 0% (Nebraska), high of 10.2% (Hawaii)
  - Affected by each state’s approach to capital spending, especially for schools
- Pension component higher: median at 3.7% of personal income
  - Range also higher: low of 0.2% (Wisconsin), high of 19.4% (Illinois)
  - Affected by disparate factors: whether state covers teachers (many states), or persistent unresolved challenges (IL, NJ, others)

States’ Pension Burdens

Wide range of states’ debt + pension burdens

- Debt figure reflects bonded debt supported by tax revenues
  - Includes POBs if they’ve been issued
- Pension figure includes unfunded liability for which state takes responsibility
  - Liability adjusted to a 7% discount rate
  - State workers in defined benefit plans
  - Certain other workers (local teachers) in others
  - Cost sharing systems allocated
    - Includes share of liability for systems with state direct subsidy

Takeaways

Old trends and new factors

- Some trends likely to continue
  - Funded ratio improvements slow, not guaranteed
  - ARC/ADC likely to remain elevated
  - Governments responding in two ways
    - Reforms (including clarifying legal limits of benefit reform)
    - Higher actual contributions
- New factors may come into play
  - ASOPs may be changing
  - Risk identification/mitigation/sharing now part of policy discussion
  - Another recession will eventually happen: impact on pensions tbd

Questions?

People in pursuit of answers

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